

Universal Care, Inc.

Notes to Financial Statements

Third Quarter Ended March 31, 2003

1. Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation

Universal Care, Inc. (the “Company”), a California corporation 100% owned by Howard E. Davis, was incorporated on April 19, 1983, for the purpose of operating a health care service plan (“HCSP”). On October 15, 1985, the Company obtained state licensure under the Knox-Keene Health Care Services Plan Act of 1975 (“Knox-Keene Act”), as amended, to operate as a staff model HCSP. On November 1, 1985, the Company purchased Vincent DePaulo, M.D., Inc., a professional medical corporation, and merged with Universal Medical Enterprises, a California corporation, which administered certain other services to the Company.

The Company currently serves approximately 315,115 enrollees, of whom 172,176 are Medi-Cal beneficiaries. Approximately 34% and 55% of group premiums and co-payments were earned from Medi-Cal beneficiaries as of March 31, 2003. In addition, the Company operates a fee-for-service medical practice at its nine health care facilities, fourteen dental facilities and two optometry facilities.

Revenues and Health Care Services

Prepaid health care premiums from enrolled groups are reported as revenue in the month in which enrollees are entitled to receive health care services. Premiums received prior to such periods are recorded as unearned premium revenue. Revenues from fee-for-service patients are recognized in the period in which the services are rendered, net of applicable contractual allowances.

The Company contracts with various hospitals for the provision of inpatient care services and with various medical groups and independent practice associations (the “Contracting Physicians”) for the provision of physician services not covered by the staff model offices. The Company compensates the hospitals on a per diem basis and the Contracting Physicians on a capitation or fee-for-service basis. The cost of health care provided is accrued in the period it is dispensed to the enrolled members, based in part on estimates of claims for hospital services, medical specialists, and other health care costs which have been incurred, but not yet settled. Given the inherent variability of such estimates, the actual costs and related liability could differ significantly from the amounts provided which could have a material adverse effect on the Company’s results of operations, cash flows, or financial condition in a future period.

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1. Organization and Summary of Significant Accounting Policies (continued)

Revenues and Health Care Services (continued)

Contracting Physicians through the use of risk-sharing arrangements. Payments are made to Contracting Physicians based on their performance in controlling hospital utilization while providing quality health care. Expenses related to the program, which are based in part on estimates, are recorded in the period in which the related services are provided. In the event that hospital utilization exceeds a pre-established budget ("Risk Share Deficit"), future incentive payments will not be made to the Contracting Physicians until the Risk Share Deficit is fully recovered.

The Company purchases reinsurance (stop-loss) coverage for its Commercial members to cover unusually high costs of inpatient care (including organ transplants), in excess of \$200,000 per member in each contract year through May 31, 2003, subject to a per member maximum of \$1,000,000 and aggregate maximum of \$5,000,000. On June 01, 2002, the company purchased reinsurance coverage which increased its retention from \$200,000 to \$300,000. Inpatient services provided in Orange County incurred on behalf of Medi-Cal beneficiaries in excess of \$100,000 per case are reinsured by the state of California. The Company has elected to self-insure inpatient services provided in Los Angeles County incurred on behalf of Medi-Cal beneficiaries. Reinsurance premiums for all providers are included in medical services expense. Reinsurance recoveries are reported in the Company's financial statements as a reduction of medical services expense.

Investments

Investments are comprised of marketable equity securities that are designated as available-for-sale. Accordingly, marketable securities are carried at fair value, as determined based on quoted prices in active markets, and unrealized gains or losses, net of applicable income taxes, are reported as other comprehensive income in shareholder's equity.

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Investments (continued)

The Company is required by state regulatory agencies to set aside funds for the protection of their plan members. At [March 31, 2003](#), such funds included debt securities held by a state regulatory agency and are designated as held-to-maturity since the Company has intent and ability to hold such securities to maturity. Held-to-maturity securities are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts to maturity, and are included in other assets. At [March 31, 2003](#), funds set aside for regulatory purposes were comprised of cash and are included in other assets.

Inventories

Inventories, which consist of prescription drugs and supplies, are carried at cost and are determined on the first-in, first-out basis, which is lower than market.

Goodwill and Intangible Assets

The Company allocates the excess of the purchase price over the fair value of the net assets acquired to goodwill and identifiable intangible assets. Identifiable intangible assets include membership. Goodwill and intangible assets are amortized ratably over periods of 10 to 20 years. Accumulated amortization totaled [\\$1,355,962 at March 31, 2003](#).

Property, Plant and Equipment

Property, plant and equipment are stated at cost, less accumulated depreciation. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized using the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the financial statements.

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Long-Lived Asset Impairment

The Company accounts for the impairment and disposition of long-lived assets in accordance with Statement of Financial Accounting Standards No. 121 ("SFAS No. 121"), "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." In accordance with SFAS No. 121, long-lived assets to be used in operations or held for disposal are reviewed for events or changes in circumstances which indicate that the carrying value may not be recoverable. The Company has determined that no long-lived assets were impaired at [March 31, 2003](#).

Cash Equivalents

The Company considers all highly liquid debt instruments purchased with a maturity of three months or less and investments in money market accounts to be cash equivalents.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of investments in marketable securities and fee-for-service receivables. All of the investments are managed within guidelines established by the Company's board of directors, which as a matter of policy, limit the marketable securities to U.S. government debt securities, municipal debt securities or certificates of deposit. Concentrations of credit risk with respect to fee-for-service receivables are limited due to the large number of payors comprising the Company's customer base. As of [March 31, 2003](#), the Company had no significant concentration of credit risk.

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Medical Malpractice Liability Insurance

The Company maintains claims-made medical malpractice liability insurance coverage for all employed physicians up to \$10,000,000 in aggregate cost and \$1,000,000 cost per claimant (with a \$25,000 deductible). Claims-made coverage covers only those claims reported during the policy period. Management estimated and recorded a liability for the cost of claims incurred but not reported in the accompanying balance sheets. Management intends to obtain medical malpractice liability insurance coverage on a claims-made basis in future years.

Each non-employee physician and contracting hospital is obligated to carry professional liability insurance in the minimum amount required by state law.

1. Income Taxes

Taxes based upon income are recorded in accordance with SFAS No. 109, "Accounting for Income Taxes."

2. Premiums Receivable

The following table summarizes premiums receivable:

	As of March 31, 2003
Premiums receivable	\$ 3,975,000
Fee for service receivables	263,671
Due from Health Net	12,315,149
Others	5,148,533
Receivables, net	<u>\$21,702,353</u>

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3. Other Assets

Pursuant to the provisions of the Knox-Keene Act, \$500,000 is held on deposit with a bank to assure the continuation of health care services to enrollees of the Company. Such funds may be used to pay current claims as long as the balance is maintained at \$500,000. The restricted cash is included in other assets in the accompanying balance sheets. At [March 31, 2003](#), \$500,000 of debt securities with an estimated fair value of approximately [\\$508,470](#) were on deposit.

The following table summarizes held-to-maturity securities:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
March 31, 2003				
U.S. government debt securities	\$ 508,470	\$ —	\$ —	\$ 508,470

4. Property, Plant and Equipment

The following table summarizes property, plant and equipment:

	As of March 31, 2003
Property, plant and equipment:	
Medical and computer equipment	\$ 18,894,573
Furniture and fixtures	2,393,191
Building and leasehold improvements	13,570,552
Construction in progress	46,010
Land	5,870,887
	40,775,213
Less accumulated depreciation and amortization	18,925,945
Property, plant and equipment, net	\$ 21,849,268

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5. Long-Term Debt

The notes payable to the Company's stockholder and officers have been irrevocably subordinated to all other present and future creditors of the Company. The subordination provision of the notes allows the Company to include the outstanding balances in determining minimum tangible net equity pursuant to the Knox-Keene Act (see Note 12).

	As of Mar. 31, 2003
Long Term Debt :	
Notes Payable to Bank	\$ 4,164,388
Notes Payable to Shareholders (subordinated)	5,999,517
Notes Payable to Related Party (subordinated)	1,540,000
Notes Payable to Individual	297,471
Long Term Debt Totals	<u>\$ 12,001,376</u>

The Company's stockholder and officers have agreed not to require repayment of certain notes payable totaling **\$7,539,517** at **March 31, 2003**. Therefore, the notes payable are included in long-term liabilities.

Maturities of notes payable other than capital lease obligations (see Note 6) are as follows:

2002	\$ 4,040,000
2003	499,517
2004	0
2005	297,471
Thereafter	<u>7,164,388</u>
	<u>\$ 12,001,376</u>

The estimated fair value of the Company's long-term debt approximates its carrying value.

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6. Commitments

Future minimum lease payments for capital leases and operating leases for office facilities and equipment are as follows:

	<u>Operating Leases</u>
2002	\$ 0
2003	494,051
2004	1,635,289
2005	1,336,318
2006	1,146,928
Thereafter through 2013	6,500,348
Total minimum lease payments	<u>\$ 11,112,934</u>

Rental expense for all operating leases, including leases with related parties (see Note 7), totaled \$2,232,126 for the nine months ended March 31, 2003.

7. Related Party Transactions

During fiscal 2002, Company purchased the Brookhurst Medical Clinic (Properties) with an appraisal value of \$1,540,000 from a related party. The purchase was financed by a subordinated note payable of \$1,540,000.

8. Income Taxes

Deferred income taxes reflect the tax effects of temporary differences between the carrying values of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

9. Contingencies

The Company is a party to certain other legal actions. In management's opinion, the Company has adequate legal defenses or insurance coverage relating to these actions, and management does not believe that the outcome of any of these legal actions will materially affect the Company's financial position or results of operations.

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10. Retirement Plan

The Company participates in a 401(k) retirement plan (the “Plan”) covering substantially all of its employees. The Company may, at its discretion, make a contribution to the Plan that will match part or all of the employee’s contribution. The Company may also, at its discretion, make a contribution to the Plan that is not a matching contribution; this allows eligible employees who have elected not to participate in the Plan to receive a contribution to the Plan on their behalf.

11. Requirements of Regulatory Authorities

The Knox-Keene Act specifies that the Company must comply with a minimum TNE requirement. Available TNE is defined as the Company’s net assets less intangibles and amounts due from affiliates, plus subordinated obligations. At [March 31, 2003](#), the Plan’s available TNE was [\\$13,968,692](#), which was [greater](#) than required TNE of [\\$9,532,360](#).